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CHINA LIGHTS

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I. CHINA: SPRATLY INTENTIONS (6/28)

Despite continuing competition with other claimants to the Spratly islands, China is showing greater willingness to discuss joint development of potential oil resources. While improving military and civilian facilities in the islands, none of the claimants, including China, appears to seek an armed confrontation.

China has repeatedly claimed sovereignty over the disputed--and possibly oil-rich--Spratly islands, which are claimed in whole also by Vietnam and Taiwan and in part by the Philippines, Malaysia, and Brunei. In 1974 China seized from South Vietnam the nearby Paracel islands, pre-empting their occupation by North Vietnam. Beijing made no move to carry out its historical claim to the Spratlys until the late-1980s, when it began extensive naval activities, scientific expeditions, and occupation of a small number of the islands.

These activities led in March 1988 to an armed but unplanned clash with a Vietnam busily increasing its own more extensive Spratly-island holdings. China's willingness to enforce its claim served notice that it intended to be a permanent force in the Spratlys and raised regional concerns it might be planning to seize the islands by force.

Upgrading capabilities. China has only limited force-projection capabilities in the widely dispersed, inhospitable Spratly archipelago, but it is taking steps to improve its strategic position.

Though the PRC lacks local air cover, it has the military advantage over Vietnam, and the balance is gradually tipping further in favor of China.

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China's calculations. To achieve its goals in southeast Asia--settling the Cambodian issue, normalizing Chinese-Vietnamese relations, and strengthening economic and political ties to ASEAN countries--China has good reason to prevent the Spratlys from becoming a major irritant. Any significant military confrontation would set back recent diplomatic achievements and rekindle regional fears of Chinese hegemony. China's recent unpublicized return of a Vietnamese boat that had been adrift in the area underscores its desire to be a peaceable neighbor.

Increasing its local military capabilities is not inconsistent with a desire to deal with the Spratly issue peacefully: China clearly believes force is a strong deterrent to would-be "bullies," a means to preserve the current balance, and a prod to negotiations.

Though unyielding on the question of sovereignty, China has stated its willingness to shelve the issue and cooperate with regional countries in joint development of Spratly resources. Deng Xiaoping first proposed to the Vietnamese in 1975 that resolution of the Spratly issue could be deferred. Last August, in Singapore, Premier Li Peng raised the idea of joint development, repeated more recently by President Yang Shangkun and Foreign Minister Qian Qichen.

China, in May, participated with Taiwan for the first time in a Hong Kong conference on the Spratlys and will probably present details of its plan at a mid-July Indonesian-sponsored seminar that is to discuss development, but not sovereignty. (MFinegan) (SECRET/NOFORN)

## II. TAIWAN/VIETNAM: AN ORPHAN AND A PARIAH GO COURTING (6/30)

Taiwan and Vietnam have warmed their economic relations, quietly. And if Vietnam can shake sanctions, the two economies could become closer partners: Taiwan has technology and capital; Vietnam has cheap labor and land. Taiwan has opened a representational office Ho Chi Minh City and apparently has the go ahead to open an office in Hanoi, but Vietnam has not yet reciprocated, apparently for budgetary and political reasons.

Since Taipei relaxed restrictions on trade and investment with socialist countries in September 1989, Taiwan businessmen have been drawn to Vietnam. Given mounting labor costs at home and in other southeast Asian countries, Taiwan businessmen view Vietnam as an attractive site for relocating labor-intensive industries such as textiles and food processing. Other incentives include cheap land, geographical proximity to Taiwan, and ethnic Chinese communities eager to do business. Vietnam's poor infrastructure and bureaucratic inertia are legendary, but some investment areas in south Vietnam are accessible to ports, and Taiwan businessmen may be willing to grease palms to facilitate arrangements.

Growing ties. During the first quarter of 1991 Taiwan's investment reportedly reached \$200 million, more than triple the total posted for 1990, making Taiwan--with France, the UK, and Hong Kong--one of the top foreign investors in Vietnam. Seventeen Taiwan firms operate now in Vietnam. Two-way trade jumped to almost \$120 million in 1990, still low by Taiwanese, but not Vietnamese, standards. Since late 1990 Taiwan and Vietnam have exchanged visits of vice-ministers in the transport and communication fields. Memoranda of understanding have been signed on investment guarantees, air transport, and reciprocal trade offices.

Taiwan's China External Trade Association opened an office this March in Ho Chi Minh city and may be planning to open another office in Hanoi. Vietnam reportedly plans to open a reciprocal office in Taipei--handling trade promotion and visa issuance. But budgetary problems and consideration of possible PRC reaction may cause Vietnam to delay its plans, at least until bilateral trade expands significantly. Each side has been a frequent exhibitors at the other's trade shows, and trade missions have been exchanged, including ones from Taiwan's leading state-owned enterprises and banks. Taiwan and Vietnamese airlines signed an agreement on June 15 permitting 12 weekly charter flights between Taiwan and Vietnam by the end of 1991.

Staying low-key. Taiwan and Vietnam have given limited publicity to their expanding ties. Besides its economic interest in Taiwan, Vietnam may not be averse to reminding the PRC it has other options, though it is reluctant to arouse PRC sensitivities or spark protests. Taiwan does not want to appear out in front of the US sanctions policy toward Vietnam. Taiwan has thus stifled its usual proclivity to publicize all the successes of its "flexible diplomacy," issuing only low-key statements about exchanges with Vietnam. Recently Taiwan informed the United States of an impending quiet diplomatic exchange with Vietnam.

Positioning for the future. Taiwan is not alone among east Asian economies hoping to gain from the eventual opening of Vietnam--South Korean and Japanese businessmen have long pressed their governments to loosen and even promote economic ties to Vietnam. Like their Korean and Japanese competitors, Taiwan businessmen expect US sanctions to be lifted in the next few years. They are preparing to exploit complementarities between capital-and technology-rich Taiwan and resource-and labor-rich Vietnam. (NSilver) (CONFIDENTIAL)

### III. JAPAN/CHINA: BUSINESS AS USUAL (7/8)

Japan's careful attention to preserving its "special relationship" with China through massive economic aid programs, a "low posture" in its diplomacy, and its recent brokerage of

Chinese interests at G-7 meetings has paid off. Prime Minister Kaifu's trip to Beijing scheduled for next month will find relations, briefly strained by the Tiananmen incident, now fully restored and remarkably free of bilateral frictions. Tokyo has used the opportunity to broaden its dialogue with Beijing to such regional issues as North Korea and Cambodia and to press for China's cooperation on arms control. Japanese corporations, some returning to China after a two year hiatus, are reaping the benefits of restored ties.

An economically sound and politically stable China has long been central to Japan's foreign policy toward Asia. The stability of the bilateral relationship is the "key to peace and prosperity in Asia," according to a Japanese policymaker. To achieve that goal, since 1979 Tokyo has underwritten much of China's modernization through massive infusions of official economic assistance and encouragement of trade, aid, and investment activities by Japan's private sector.

Broadening the Dialogue. Japan recently has begun to adjust its relations with China to reflect its ongoing search for an expanded political role in the region. In the past, Japan regarded a friendly China mainly as a useful counterweight to the Soviet Union, but recently, particularly since the Gulf crisis, Japan has broadened its policy dialogue beyond that stock formula. It is now urging Beijing to play a responsible regional role by exerting influence over North Korea and over the Khmer Rouge in Cambodia. Tokyo also has pursued a campaign to impress on China its international responsibilities as a major arms supplier and a permanent member of the UN Security Council, urging it to restrain arms shipments to the Middle East and other unstable areas.

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[REDACTED]

But Unwilling to Take a Tough Line. Japan typically maintains a "low posture" in its diplomacy toward Beijing during periods of strain and tension. Japan's sensitivity to its own past human rights abuses in Asia explains the reluctance to press China strongly on its continued poor performance on human rights. It also reflects a strong Japanese conviction that Asians are best able to deal with each other in a non-confrontational way. Since Tiananmen, Japan's efforts at the G-7 to prevent China's "isolation" from the West have earned it Beijing's appreciation, but Tokyo is unwilling to exploit fully its new leverage. The Japanese claim that strong pressure on the Chinese would be counter-productive, but behind it may be concerned that "frictions" might reappear between Beijing and Tokyo. The Japanese prefer to couch their reform arguments to China in terms of potential economic benefits, rather than principle, the assumption being that over the long term China's modernization and the improved welfare of its people inevitably will lead to meaningful reforms.

Economic Aid the Backbone of the Relationship. Japan is China's top aid donor, having disbursed since 1979 over \$6 billion in two packages of soft "yen loans" mainly for infrastructure projects. During 1990-95, it will provide almost \$6 billion more worth of yen credits in a third loan package. Japan's Eximbank also has provided over \$6 billion in energy loans since 1979. Sensitive to Western criticism, Japan has gradually untied procurement in its yen loans to China, and the current package is 100 percent untied. This has not precluded Japanese companies from reaping the benefits of close economic ties. For example, the top four bidders for the first project of the restarted third yen-loan package--a fertilizer plant--were Japanese companies, although two had Italian partners. For Japanese firms, an active in-country presence and years of cultivating close business contacts appear to be paying off. (BBrooks) (CONFIDENTIAL)

#### IV. NARCOTICS: A NEW OPIUM WAR IN SOUTHERN CHINA (7/16)

Southern China is experiencing an alarming increase in drug trafficking and addiction. Beijing has responded with aggressive enforcement measures but has been slow in addressing domestic opium cultivation and Burmese trafficking groups operating in or through China.

An unprecedented opium and heroin boom in Thailand, Burma, and Laos in recent years has caused an expansion of trafficker operations and routes into southern China. Yunnan province has become an important pipeline for Burmese heroin en route to Hong Kong and western markets. Opium cultivation by Burmese ethnic minorities has spilled over into remote and poorly controlled areas of southern Yunnan province, where production seems to be spreading.

[REDACTED]

Growing domestic problem. The influx of high-quality Burmese heroin has been accompanied by a number of drug-related social ills. Official estimates of 70,000 drug abusers nationwide are probably a gross understatement. Local press reports recently cited over 100,000 addicts in Yunnan province alone. Abuse has spread from rural border regions to major cities, and drug-related HIV infection has begun to spread rapidly along the China-Burma border. Drug-related crime and corruption within the military and police also appear to be on the rise.

Until the late 1980s Beijing disclaimed any serious drug problem. But over the last two years provincial authorities in the south have called attention to a resurgence of the drug threat. Beijing has been prompted to implement tough new

measures, including stepped-up executions of drug traffickers, and special enforcement task forces. By December 1990 the government had created a national anti-drug committee, and last month a national conference in Beijing declared a "people's war" against drugs. According to Chinese figures, more than 2,400 kilograms of heroin and opium were seized last year and some 5,600 people arrested, compared with 33 kilos seized and 10 people arrested six years ago.

Old habits die hard.

[REDACTED]

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Chinese officials have supported crop substitution on both sides of the border, but they have also tried to use aid--as well as persuasion and threats of arrest--to keep Burmese drug groups from operating in or through China, and this aid has hampered Burmese efforts to control the groups.

Outlook for US cooperation. Local officials have been candid with visiting US delegations in assessing the drug problem and have appealed for US training and assistance. Beijing, however, has been cool towards expanding bilateral cooperation: in early 1990 Beijing allowed an imprisoned Chinese criminal, Wang Zhongxiao, to come here as a witness in a case involving heroin smuggled to the United States in shipments of goldfish from China; Wang sought political asylum, and his request is pending with INS. Beijing has increasingly linked the future of US anti-drug cooperation to a US ruling that would return Wang to China.

Though a decision to deny Wang asylum would eliminate the immediate impediment to a more fruitful counternarcotics relationship, improved cooperation would probably continue to be hampered by the general climate of tension in bilateral relations. (INR/TNA:MBTaylor) (SECRET/NOFORN)

#### V. TAIWAN'S QUEST FOR ARMS (7/10)

Taiwan's efforts to procure major weapons systems from non-US sources will score a significant success if the recently-revived deal for French Lafayette-class frigates is consummated. Taipei seeks additional suppliers to overcome limitations on US arms sales to Taiwan, ease its political isolation, and to pressure the US to meet its requests for additional and/or more advanced arms. PRC protests to potential suppliers will be offset by the allure of major military--and implicitly linked civilian--sales to Taiwan. If significant sales by non-US suppliers ensue, Beijing will not blame the US directly, but the sales will likely raise PRC sensitivities to US arms relations with Taiwan.

Searching for a Breakthrough. Over the years, Taipei's efforts to purchase arms from countries other than the United States have met with little success because potential suppliers have been unwilling to jeopardize ties with Beijing. This impediment was reinforced when Beijing downgraded relations with the Netherlands (from 1981 to 1984) to protest a Dutch submarine sale to Taiwan.

[REDACTED]

[REDACTED] Taiwan wants not only to fill perceived military needs, but also to score precedent-setting political breakthroughs that would facilitate future arms acquisitions.

[REDACTED]

Strategies. For European suppliers, the multi-billion dollar pricetags on major arms deals and the lure of special consideration for costly infrastructure development contracts provide incentives to deal with Taiwan. In attempts to make possible arms deals with Taiwan more palatable to Beijing, European countries are promoting sale of unarmed ships, and some have proposed transferring technology rather than products to Taiwan.

[REDACTED]

[REDACTED] All countries have proceeded cautiously to gauge Beijing's reactions before going ahead.

[REDACTED]

Possible PRC Reactions. Beijing will lobby hard and protest vociferously to prevent a precedent-setting, major non-US-sourced arms deal. It will threaten unspecified damage



to bilateral relations in hopes the other side will decide the risk of damaging ties is too high to justify going through with any sale to Taiwan. If unsuccessful in blocking a deal, the Chinese will likely try to extract an agreement not to sell more. Beijing may be reluctant to downgrade relations with a major country [redacted] to drive home its displeasure with a sale and/or extract a promise not to make future sales, as to do so would set back its drive to normalize ties with EC countries. [redacted]

Ramifications for US-China Relations. Since conclusion of the August 1982 communique limiting the future quantity and quality of US arms sales to Taiwan, Beijing protests to the US have been sporadic and generally low key, despite recurring conflicts over interpretation. [redacted]

[redacted] In all other cases under consideration, the sale of major systems or technology to Taiwan by non-US suppliers would not directly spur Chinese protests to the US. Nonetheless, such sales would raise PRC sensitivity to US arms sales to Taiwan, possibly ratcheting up still low-key PRC protests over US dealings with Taiwan. (MFinegan) (SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

#### VI. CHINA'S DEFENSE CONVERSION: LESSONS FOR THE USSR?

Both China and the USSR are struggling to switch militarized economies to more market-based, consumer-oriented systems. The Chinese have moved further along this uncharted path and may offer lessons--both positive and negative--for the Soviets.

China's program was launched in the late 1970s as part of a massive industrial modernization plan. Civilian goods now account for 70 percent of defense industrial output, compared with barely 20 percent a decade ago. The defense sector--still largely state controlled--is producing an impressive array of capital equipment and large quantities of consumer goods for export as well as domestic consumption. A Chinese-sponsored international conversion conference is planned for this fall.

The Chinese Approach. China's "conversion" program is equivalent to what the USSR calls "diversification." Under this approach, military production capacity is--in US terminology--"laid away" on site, where it is used far below capacity or not at all while resources are concentrated on civilian production.

This extremely costly system runs counter to advice offered by most US and West European industrial specialists, who recommend "mothballing" or scrapping excess or obsolete weapons

tooling. Lack of confidence in mobilizing industry for a military emergency apparently accounts for Beijing's approach, as well as Moscow's.

Conversion efforts have been complicated by the strategically remote location of China's "third tier" defense industries, which have long isolated the country's best S&T and manufacturing assets from the technology-starved civilian industrial base on the coast. In addition to "diversification" at existing weapons plants, a major development is the relocation of personnel and equipment to coastal regions where new, "totally civilian" industrial plants are being spun off.

These new plants are still considered to fall under defense industry auspices, but in some cases they have received financial support from provinces, cities, or towns. Although these government units are partial "owners" of such plants, stock cannot be sold. Individuals hold no equity in the vast majority of these companies.

Incentives for Defense Industry. Faced with slumping military orders, many defense industrial managers have seen expansion into the successful civilian manufacturing sector as an increasingly attractive alternative. Chinese defense managers are given broad authority to select their own civilian product lines, although a veto power is retained at the ministerial level. The lure of big profits, higher wages, hard currency, and relocation from the remote interior to economically active coastal regions are important factors driving conversion.

Another factor helping the transition is Mao's legacy of preventing too much disparity between the wages and perks in China's military-industrial complex and those in civilian enterprises. The Chinese are not facing the dilemma of Soviet counterparts, who see switching to civilian products as the end of their special privileges.

Overcoming Obstacles. China's entry into new civilian products has been heavily based on imported technology and equipment. From 1978 to 1987, China imported more than 2,500 pieces of high-technology equipment for the machine-building sector alone, significantly enhancing its capabilities in microelectronics, pharmaceuticals, motor vehicles, and machine tools. Many of these imports have been instrumental in defense plants being able to diversify into civilian production.

Switching to civilian products has been an arduous undertaking on other counts as well. Plants in remote locations face special difficulties establishing contact with domestic or foreign firms that might provide the capital and technology to develop new products. Lack of access to road and rail transport pushes up production costs. Some industries that have made the transition, particularly electronics plants, find it difficult to compete in a rapidly changing marketplace.

Layoffs have been temporarily averted only by some form of bailout from Beijing. A number of plants are receiving national and provincial budgetary subsidies and loans to bridge their move to civilian production.

In some cases Beijing has opted to keep military production lines in operation by expanding weapons exports. Weapons plants are still state owned and the government continues to guarantee their priority access to raw materials, electricity, and transportation. Hard currency earnings from foreign arms sales have helped fund technical modernization of military plants, although it is unclear to what extent such earnings have been used to aid conversion to civilian production.

Officials maintain it would be impossible to abandon the remote defense "company towns," because of the state's obligation to provide jobs, housing, and other social needs. Rigid socialist habits, combined with lack of experience in tailoring production decisions to market demand, hamper conversion efforts.

High-Tech Zones. China has two programs, "Torch" and "863," which are designed to promote the commercialization of research work and the advancement of Chinese technology. Military plants interested in conversion are participating in these economic development programs as much as possible to help facilitate transition to civilian production, according to Jin Zhude, director of the China Association for Peaceful Use of Military Industrial Technologies (CAPUMIT).

Under Torch, announced in 1988, more than 20 national-level zones have been created--many in commercially accessible coastal areas--to develop and manufacture new products for domestic and international markets. The State Council assists the high-tech-zone industries with favorable bank loans, export-promoting regulations, and tax incentives. Zones in the northeast are well placed to take advantage of the large concentration of defense industries there, while zones in south-central China will take advantage of that area's aviation and space industries, according to Embassy Beijing.

Through the "highly sensitive" 863 program--established in March 1986, hence the 86/3 designator--Beijing seeks to narrow the S&T gap with advanced countries by the year 2000. The program, which involves many military S&T facilities, centrally coordinates priority technologies in an effort to accelerate their development and application for commercialization as well as new weapons development. The priority technologies--all dual use--are: space, lasers, biotechnology, information systems, automation, high-energy sources, and advanced materials.

Although 863 is designed to support both military and commercial applications of new technology, the defense sector

was assured priority when the program was established, a policy underscored by Beijing since the Gulf war. According to conversion officials, defense industry managers are eager to participate in both Torch and 863 because these programs provide improved access to funds for research, retooling, marketing assistance, and help with exports.

Results Paying Off. The 70-percent civilian and 30-percent military ratio of defense industry output is corroborated by the sector's sixfold increase in production of civilian goods in the first decade of conversion: from \$700 million in 1979 to \$4.7 billion in 1989. Civilian exports are estimated to have grown about 20 percent annually in recent years. TVs, radios, electronic components, toys, hand tools, electric appliances, kitchenware, and textiles have been important factors in the dramatic rise in China's foreign sales, especially to the US. About 30 percent of defense industry exports are in rapidly growing, technology-intensive areas, where the Torch program is expected to spur export growth even further.

Problems Remain. Jin Zhude sees lack of funds for retooling as a continuing stumbling block in China's conversion program. The state does make loans to military plants that want to switch production, but such financing is insufficient. Jin's hope is that China's large supply of highly trained, low-wage defense industry personnel will attract foreign investors, who will gear their products for export, especially in electronics and household appliances.

The focus is on exports because civilian industry can now meet domestic demand for many consumer products. Exports generate hard currency which can be reinvested to promote modernization.

Civilian plants, according to Jin Zhude, bitterly oppose new competition from military factories, especially in machine building and electronics where the defense sector has strong capabilities. For example, last year the premier Changhong TV plant--an important military electronics producer--sharply reduced prices in order to move excess inventory. This outraged domestic competitors who appealed--to no avail--to the state pricing authorities in Beijing to stop the discounting. Clearly, China's consumers stand to benefit from lower prices as conversion progresses.

Mentor Learning From Student? One of the discussion topics during General Secretary Jiang Zemin's May visit to the USSR was China's success in shifting military enterprises to civilian purposes. The extent to which Soviet defense-industrial leaders are already philosophically attuned to Beijing's type of state-administered restructuring is apparent in the following similarities in their approach:

Reduce the strategic threat perception; cut defense spending and weapons production.

Centrally control conversion policy and implementation.

Continue state direction of strategic industries.

Strip away secrecy from weapons facilities and technologies.

Integrate civilian ministries with defense industry.

Encourage defense-to-civilian technology transfer.

Keep military production lines "warm" or "laid away" through "diversification."

Retain defense industry's priority access to materials.

Subsidize financially weak defense plants.

Seek foreign financial and technical involvement.

The USSR's defense industry and ministerial bureaucracy are much larger than China's, however, and the resistance of Soviet defense managers to change is proportionately stronger. Chinese defense managers also have had a relatively successful civilian model to follow, whereas their Soviet counterparts still see few economic reasons to push conversion.

USSR Faces the Inevitable. As Moscow makes sharper cuts in weapons procurement, Soviet defense managers will have little choice but to civilianize their product lines. If the Chinese model is followed, the heavyhanded Soviet ministerial hierarchy will have to be overhauled. Gorbachev already has suggested that, as economic reforms progress, these ministries will be slimmed down and transformed into purely policy-setting institutions with little operational control. At the same time, defense managers will have to be granted much greater authority in running their enterprises.

A Soviet Advantage? If political and economic reforms in the USSR result in a high degree of local autonomy under a new Union treaty--and if large-scale foreign lending and investment become a reality--the USSR's conversion might face fewer obstacles than China's. Soviet defense plants, the military R&D system, and the country's overall economic infrastructure are clearly superior to those in China a decade ago. Although many plants are located beyond the Urals in defense "company towns," they are not nearly as isolated as China's "third tier."

Moreover, there are hundreds of major plants in Moscow, Leningrad, and other industrial cities far closer to potential domestic and international markets than in China's case. Even in the current unsettled environment, some Soviet defense managers have been pursuing Western technology, capital investment, loans, and joint ventures because they see access to international markets as the key to successful conversion.

### China's Conversion Apparatus

The key organizations responsible for coordinating and implementing conversion policies are the:

Commission on Science, Technology, and Industry for National Defense (COSTIND);

State Planning Commission (SPC);

State Science and Technology Commission (SSTC); and

High-Technology Plan Coordination Group.

Three streamlined ministries--Energy Resources, Machine Building and Electronics, and Aerospace--were formed in the mid-1980s to implement conversion. Subordinate to the State Council, these new ministries have broad policy-enforcement and monitoring responsibilities over their affiliated civil and military plants. Day-to-day operational control varies by ministry but in most cases is relatively limited. The ministries' primary role has been to provide direction, financing, and domestic and foreign contacts. They also monitor numerous "trade corporations" that were created to support the import and export needs of the plants.

Several hundred additional plants are under the direct control of the People's Liberation Army (PLA), which is subordinate to the Military Commission.

The three new ministries and COSTIND are breaking down the defense industry's wall of secrecy by promoting cross-sectoral information exchanges, the publication of journals devoted exclusively to conversion, and exhibitions at home and abroad.

An important player in the process is the China Association for Peaceful Use of Military Industrial Technologies (CAPUMIT). According to General Director Jin Zhude, CAPUMIT is a "nongovernmental" organization which helps coordinate conversion policies among various organizations in the Chinese Government. Its advisory council, however, is composed of the vice ministers of the key state organizations responsible for economic and defense policy, including COSTIND's deputy director, Huai Guomo. (INR/EC:RLDavis) (SECRET/NOFORN)

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